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**INVESTMENT RESTRICTIONS
IN THE FINANCIAL SERVICES SECTOR**

Edwin H. Neave, Queen's University

Working Paper 2008-08

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Abstract

This paper attempts to assess the formal and the informal dimensions of Canada's policy toward foreign direct investment (FDI) in financial services. After examining both customary approaches and Canada's legislation, the paper concludes that historically the most important formal FDI restrictions have affected the banking industry. While most of the formal restrictions have now been removed, differences in past policies mean Canada's banking and insurance industries currently differ in structure. Canada has a banking industry with a large domestic component and a fringe of foreign-owned, mostly small banks, while the insurance industry is considerably more international in both ownership and the types of business it conducts.

Canada's current legislation still requires that the shares of large banks and the two largest, recently demutualized insurance companies, be widely held. While the widely held limitation is not regarded by the Organisation for Economic Co-operation and Development as a deviation from national treatment, and while it does not discourage foreign portfolio investment up to legally permitted maxima, it does limit the possibility of acquiring a controlling voice in institutional affairs. There have been no foreign applications for acquiring a significant degree of ownership in a large Canadian bank, possibly indicating either a lack of investor interest or a belief that a proposal to acquire a block of shares might not receive welcoming treatment in the required ministerial approval processes.

Key words: *FDI, foreign direct investment, foreign direct investment restrictions, financial services sector*

Résumé

L'étude tente d'évaluer les aspects officiels et officieux de la politique canadienne en matière d'investissement direct étranger (IDE) dans le secteur des services financiers. Après avoir examiné et les approches habituelles et la législation canadienne, nous tirons la conclusion que traditionnellement, les obstacles directs les plus importants ont visé le secteur des services financiers. Bien que la plupart des obstacles officiels aient maintenant été éliminés, les divergences de politique du passé ont fait en sorte que l'industrie des services financiers et celle de l'assurance ont des structures différentes. L'industrie bancaire canadienne est composée en grande partie d'acteurs nationaux, avec quelques banques étrangères, généralement de petite taille, alors que l'industrie de l'assurance est nettement plus internationale à la fois du point de vue de sa propriété et de ses pratiques d'affaires.

La législation canadienne actuelle exige toujours que les grandes banques et les deux plus importantes entreprises d'assurances récemment démutualisées soient à participation multiple. Bien que cette exigence ne soit pas vue comme une entorse au traitement national par l'Organisation de coopération et de développement économiques, et bien qu'elle n'empêche pas l'investissement étranger jusqu'au maximum permis, il reste qu'elle limite la possibilité de diriger les activités de ce type d'entreprise. Il n'y a eu aucune tentative étrangère d'obtenir une

participation significative dans une des grandes banques canadiennes, ce qui indique peut-être un manque d'intérêt des investisseurs ou l'impression qu'une proposition d'achat d'un bloc d'actions ne franchirait pas le processus d'approbation ministérielle obligatoire.

Mots clés : IED, l'investissement direct étranger, obstacles à l'investissement direct étranger, secteur des services financiers

EXECUTIVE SUMMARY

Foreign direct investment (FDI) in Canadian financial services is lower, relative to industry size, than in a number of other OECD countries. While the differences might be due to either formal or informal barriers, the factors involved have yet to be fully determined. Information regarding FDI barriers for any of the OECD countries is relatively sparse, and the few available studies document only formal restrictions. The extent and types of informal limitations remain to be investigated.

Firms wishing to enter business in a new country can face many types of formal obstacles, including limits on equity holdings, strictures on the firms' governance structures, and restrictions on the types of operations they can conduct. Impediments to FDI can also extend beyond specific provisions. Differences in market structure, differences in tax policy, and differences in corporate governance practices can affect investment decisions. Still other factors can also be at play. Some countries have restrictive anti-trust, innovation or technology policies that can negatively affect FDI proposals. As a result of either explicit or hidden subsidies, state-controlled enterprises may gain advantages relative to private sector firms. Finally, some of a country's policies may be unpublished, rendering formal approval procedures for investment applications less than wholly transparent.

This paper attempts to assess both the formal and the informal details of Canada's policy toward financial services FDI. It begins by considering such customary approaches as restrictiveness scores and estimates of economic impact. The paper then surveys Canada's legislation regarding financial services FDI, concluding that while historically the most important formal restrictions have affected the banking industry, most of those former restrictions have now been removed.

To demonstrate the historical effects as vividly as possible, the paper compares and contrasts the current structure of the banking and insurance industries. Current restrictiveness scores for the two industries are essentially similar, but the nature of FDI in the two industries has been quite different, and as a consequence the industries' current ownership composition is equally different. Today Canada has a banking industry with a large domestic component and a fringe of foreign-owned, mostly small banks, while the insurance industry is considerably more international in both ownership and the types of business it conducts.

The differences between the banking and insurance industries are explained both by the formal regulations of the past and by the manner in which government policy has been expressed. In the 1960s Canada actively discouraged the entry of foreign banking. Since then legislative revisions have successively relaxed the constraints. The most recent changes are in Bill C-37, passed into effect April 20, 2007. The cumulative effect of the changes is a policy stance that is now more open than it has been historically. Currently, as in many other OECD jurisdictions, formal restrictions on foreign banking entry are expressed mainly through requirements for Ministerial approval.

However, Canada also has laws requiring that the shares of large Canadian banks and the two largest, recently demutualized insurance companies,¹ be widely held. This limitation affects both domestic and foreign investors and is therefore not regarded by the OECD as a deviation from national treatment. The widely held restriction does not formally discourage foreign portfolio investment up to the legally permitted maxima, but it does limit the possibility of acquiring a controlling voice in institutional affairs. Moreover, the original intent of the legislation was explicitly to limit foreign ownership of large Canadian banks.² Whether the thrust of the legislation has continued to discourage attempts to acquire shareholdings in large banks has not recently been investigated³ and can therefore be only a matter of speculation. A research proposal that offers some possibilities for assessing the possible past and current effects of the widely held rule is given in the paper.

A full assessment of Canada's investment climate should also consider possible perceptions regarding Ministerial review processes. A foreign investor will not undertake the time and expense of trying to set up a new business venture unless he can be reasonably confident that the Minister of Finance will be likely to approve the application.⁴ At present, minor technical applications usually receive routine approval, but there have been no foreign applications for acquiring a significant degree of ownership in a large Canadian bank. The lack of attempts to acquire block shareholdings might suggest either a lack of investor interest or a belief that historical attitudes still hold sway and approval would not be forthcoming. Moreover, although it too is a matter of speculation, current and past governments' stated policies respecting domestic mergers might contribute to such a belief: if domestic mergers are not regarded with favour, is there any reason to suppose foreign acquisitions would receive a more welcoming treatment?

It is not easy to say whether the nature of the payments system currently presents any informal barrier to FDI. Authorized foreign banks established under the Bank Act must be members of the Canadian Payments Association, and as such have access to the payments system. Accordingly, authorized foreign banks could conceivably set up their own ABM network, although none have thus far, possibly because of perceived difficulties in competing with established networks.

As legislative requirements have been progressively relaxed in recent years, the possibilities for successfully establishing a foreign banking business in Canada have increased commensurately. While it is not considered a foreign bank under the Bank Act, the most prominent current example of a foreign presence is that of HSBC Bank Canada.

¹ This type of treatment is not measured by OECD assessments such as are found in Koyama and Golub (2006). The assessments aim primarily to measure deviations from national treatment, rather than the institutional environment more generally.

² The legislation was first passed in 1960 and at that time covering only the banking industry. Its stated purpose is documented in Garvey and Giammarino (1998).

³ Garvey and Giammarino reach mixed conclusions about the legislation's impact.

⁴ As is well known, it is common business practice in many parts of the world to investigate the investment climate before making formal applications.

HSBC Bank Canada operates the country's seventh largest bank, a business with some 140 branches. The asset and branch sizes of HSBC Bank Canada have been built up mainly through acquisitions. Since legislation defines HSBC Bank Canada as a medium-sized establishment, it is not subject to the widely held rule. Consequently, the example suggests that while Canadian policy might still be perceived as discouraging a significant foreign banking presence, it has not presented insuperable obstacles to a determined entrant.

Turning from banking to the overall nature of Canada's financial services, the absence of a federal securities commission constitutes a serious impediment to issuing and trading securities in Canada, and may therefore also affect FDI. Canada's fragmented, provincial approach to governing the securities industry is almost unique among WTO countries. It is costly both to the players and to the country, and equally seriously, could also constitute an impediment to technological progress.

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1. Introduction

1.1 Overview

This paper attempts to assess the formal and informal characteristics of Canada's policies toward financial services FDI. It first considers customary approaches such as calculating restrictiveness scores and estimating economic impact with the aid of regression and simulation analyses. The paper then surveys Canada's current legislative environment regarding the financial services industry, finding that in the past the most important restrictions have affected the banking industry.

To demonstrate the differential effects of past policies, the paper compares and contrasts banking and insurance, reporting the Koyama-Golub restrictiveness scores and interpreting them in the light of the two industries' industrial organization. At present the scores for the two industries are almost identical. However the nature of FDI in the two industries has differed considerably, resulting in current differences in their industrial organization. In 2007, Canadian banking is essentially a domestic industry with a fringe of foreign-owned, mostly small banks. In contrast, the insurance industry is considerably more international in both its ownership and the types of business it conducts. Canada has two large domestic, demutualized companies (Sun Life and Manulife) a domestic, closely-held insurance company (Great West Life), and a number of foreign life and health insurance companies as well.⁵ Property and casualty insurance in Canada is largely carried on by foreign companies.

Historically, Canada has sharply limited the entry of foreign banking. However, governmental attitudes have changed over the years, and Canada's current restrictions on foreign banking are now expressed mainly through required Ministerial approval processes. But in addition, legislation provides that the shares of Canada's large banks and the two large demutualized insurance companies provides must be widely held. Since this limitation affects both domestic and foreign investors, it is not regarded in OECD publications as a deviation from national treatment. The widely held restriction probably does not discourage portfolio investment, but does limit the possibility of acquiring a significant voice in institutional affairs.⁶

A current assessment of financial sector policy is not complete without considering the informal climate.⁷ A foreign investor will not undertake the time and expense of trying to set up a new business venture unless he can be reasonably confident that the Minister of Finance will approve the application.⁸ At the present time, minor

⁵ Canada's large insurance companies were historically organized as mutuals, and consequently faced no possibility of foreign takeovers until after demutualization.

⁶ "...(T)here is no direct evidence that the shares of Canadian banks are systematically undervalued relative to US banks. Despite this, indirect evidence on monitoring and the value of control suggest that ownership restrictions can be harmful to shareholder value." (Garvey and Giannarino, 1998:5).

⁷ While the paper has identified some informal impediments, its catalogue cannot be regarded as comprehensive because informal barriers are difficult to uncover.

⁸ As an example of the effects of ministerial attitudes, domestic banks have indicated a desire to merge since 1998. Although in latter years the Department of Finance has indicated that it would support the idea

technical applications for approval are usually granted routinely. On the other hand, there have been no foreign applications for acquiring a significant degree of ownership in a large Canadian bank.

As legislative restrictions have been progressively relaxed, the possibilities for successfully establishing a foreign banking business in Canada have increased commensurately. While not considered a foreign bank under the Bank Act, the most prominent current example of a foreign presence is that of HSBC Bank Canada. HSBC Bank Canada operates the country's seventh largest bank, a business with some 140 branches⁹ that have been acquired mainly through acquisitions. Since legislation defines HSBC Bank Canada as a medium-sized establishment, it is not subject to the widely held rule. Consequently, the example suggests that whatever the informal effects of Canadian policy on foreign bank entry, it does not present insuperable obstacles to determined entrants.

Turning from banking to the overall nature of Canada's financial services industry, the absence of a federal securities commission constitutes a serious impediment to issuing and trading securities in Canada. Canada, almost uniquely among WTO countries, governs its securities industry on a provincial basis. This approach is costly both to the players and to the country, and could well have the effect of impeding both FDI and concomitant technological progress.

1.2 Background

Canadian attitudes toward foreign direct investment have varied substantially over the years. Expression of these attitudes ranges from the restrictiveness of the former Foreign Investment Review Agency and 1960s Bank Act provisions to the relative openness manifest in Bill C-37, which came into effect on April 20, 2007. The principal long-term change has been gradual relaxation of restrictive legislation.

Around the year 2000 the OECD characterized Canada's financial sector equity restrictions as relatively stringent, her management and operational restrictions as notably strong, and her statutory screening requirements as pervasive. In a more recent study, Canada's formal restrictions on non-manufacturing industries were still estimated as being above the OECD average (Koyama and Golub 2006). FDI proposals can also be affected by provincial limitations that are not always documented in the assessments just cited. But despite the foregoing, FDI proposals can currently be pursued with few restrictions other than the need to satisfy ministerial approval processes.

Informal barriers may complicate the picture further, but they are difficult both to identify and to discuss. New businesses ventures will not be pursued if identified risks loom too large in relation to expected profitability, but there can be many different ways

of mergers, ministerial approval is still required for such a change, and the present government has stated publicly that mergers are not a priority at this time.

⁹ However it is important not to overemphasize the importance of this operation. Canada's banks operate a total of nearly 8000 branches.

in which new ventures are inhibited. In essence, identifying all informal restrictions amounts to asking what business applications are discouraged because an investment climate is not seen as favourable.¹⁰ Obviously, no single paper can investigate all such possibilities.

Although it results principally from private sector decisions rather than from governmental attitudes, access to the payments system may sometimes function as a barrier to entry. Authorized foreign banks are required under the Canadian Payments Act to be members of the Canadian Payments Association, but for risk mitigating reasons membership restrictions affect various types of domestic and foreign businesses.

On another topic, the provincial organization of Canadian securities legislation still constitutes a serious impediment to domestic and foreign investors alike. The resulting restrictions are attributable mainly to federal-provincial differences. In particular, Canada appears to have been unable to find ways of passing some of the benefits that would derive from national securities regulation to the provinces whose business might be attenuated. The greater good would be served by national securities regulation, but in some cases individual provincial interests could be affected detrimentally, and it is important to find ways of recognizing the impacts of this conflict.

2. Theoretical Literature

To establish a context for the subsequent analysis, this section summarizes themes in the theoretical and empirical literatures on financial systems.¹¹ A large body of theoretical literature, supported by a considerable body of empirical research, argues that restrictions on foreign entry can have significant negative economic impacts. Limitations to foreign entry can inhibit financial services competition, raise net interest margins, and even slow technological progress. For example, Levine (1996) argues that permitting the entry of foreign banks can bring more competition to the banking sector, greater access to foreign capital, and enhanced development of the domestic financial regulatory framework. Although the literature contains few exceptions to the view that relaxing constraints is desirable, Stiglitz (1993) points out that foreign entry can prevent small domestic firms from using foreign capital and in addition can lead to governmental loss of control over economic policy. While Stiglitz' concerns appear to have limited application to the contemporary Canadian scene, some of the same issues have figured prominently in Canadian debates of the past, and may to some extent still colour contemporary attitudes.

Foreign banking varies considerably in importance across countries, largely as a result of differences in national policies. Cetorelli and Gambera (1999) report that there is a limited foreign bank presence in most countries, with median foreign bank asset shares being some six percent of the total. Claessens, Demirgüç-Kunt and Huizinga (2001)

¹⁰ For example, a recent CD Howe Research Institute study (2007) concludes that a web of counter-productive tax rules inhibit the inward flow of private equity investment.

¹¹ The literatures are vast, and can only be sketched here. The present summary relies substantially on the extensive review in Lu, Tang, Fung and Sabbagh (2003).

observe that foreign banks tend to be numerous and small in most countries (including Canada). Moreover, foreign bank operations tend to be more profitable in developing countries, less so in developed countries.

The literature offers conflicting views on relations between concentration, interest rates and financial product prices. Heitfield and Prager (2002) offer evidence that some types of banking products are local in scope, and are thus unlikely to be affected significantly by national policies. Berger and Hannan (1989), Hannan (1990, 1997) and Prager and Hannan (1999) also argue that small business loans are local and that higher local market concentration is correlated with higher interest rates.

Interest rate differences in particular retail markets are more likely to reflect differences in local competition than differences in national attitudes. Mallet and Sen (2001) observe that the number of local competitors and small business loan rates are negatively related in Canadian financial markets. For example, rates for loans of \$100,000 and lower in an area with four or more competitors are roughly 29 basis points lower than loan rates in an area with one institution. Mallet, Sen, and Sondhi (2001) find no statistical support for lower loan rates due to either national or electronic competition.

Rhoades (1996) finds that banking competition is quite different in local and in global markets. Since retail banking is distinct from corporate and wholesale banking, changes to entry policies could well have differential effects on particular markets. English (2002) points out that net interest margins are affected principally by individual countries' interest rate risks. If one regards Canadian and US interest rate risks as comparable, English' observations are supported by his finding that net interest margins for the two countries are also roughly comparable.

McIntosh's (2002) simulations show that prices for Canadian banking services are likely to fall after a merger, since there are sufficient economies of scale to offset the lessening of competition. However, McIntosh examines banking services as a whole, and does not consider specific banking products. A review by Amel et al. (2002) finds little evidence of large economies, either scale or scope, in international mergers. Allen, Engert and Liu (2006) argue that Canadian and US banks are roughly comparable in key productivity ratios and other measures of efficiency. However, they also argue that Canadian banks may be too small to realize the full extent of available scale economies. In support of this observation, the authors compare dispersion in cost-inefficiency data to infer that Canadian banks may not invest as fully as their US counterparts in new technologies.¹²

The literature on how countries regulate foreign banking is relatively small. In major contributions Barth, Caprio and Levine (2001, 2006) assemble a database regarding regulation of banking across the world and draw policy conclusions from their research. They find no statistical relationships between the regulation and banking

¹² A foreign bank concerned about Ministerial approval of an application might note that although domestic banks have offered the scale economies and technological improvement arguments in their attempts to merge, the governments of the day were not persuaded.

margins, nor between margins and concentrations. They argue, however, that relatively stringent regulation probably has more negative impacts than does a policy of greater transparency, fewer restrictions, and market valuation of the entities involved. Economies can pay a greater price for following an industrial strategy than for following a laissez-faire approach. Williams (1998) examines foreign banks in Australia and finds that regulation affects their size but not their profitability. Demirguc-Kunt, Levine, and Min (1998) observe that foreign-bank ownership is not necessarily linked to the likelihood of a financial crisis.

Canada's widely held provision regarding the shares of large domestic Canadian banks applies to both domestic and foreign shareholders, but has nevertheless been viewed by some authors as an impediment to the latter (Garvey and Giammarino 1998, Gouvin 2001). Obviously, the widely held rule can affect ownership composition and the possibility of acquiring effective control. A further implication is identified by Lai and Solomon (2006), who provide both a theoretical framework and empirical support to show that large block-holdings of shares can lead to larger debt issues and consequently greater discipline of the managers of such institutions.

Trade restrictions and market regulation can also inhibit FDI, as can corporate taxes (Yoo, 2003). Moreover, combinations of restrictions can have adverse effects on both FDI and consequent technology transfer (Conway et. al, 2006).

3. Methods for Quantifying Restrictions

Findlay and Warren (2000) summarize the process of assessing restrictive regulations and their likely impacts. First, available qualitative evidence is collected to compare how nations discriminate against potential entrants in various service industries. The evidence is then transformed into a frequency index that attempts to weight discriminatory policies by their economic significance. The impact of these policies is then further assessed against cross-national differences in domestic prices or domestic quantities. The methodologies determine a benchmark price or quantity and attribute part or all of a divergence from the benchmark to restrictions. Finally, the coefficients of the frequency indexes are incorporated into partial or general equilibrium models to assess the economy-wide impacts of the policies in question. The models attempt to estimate the effect of restrictions on the outputs, prices and in some cases the costs of service suppliers.

3.1. Weighting formal barriers to investment

The most widely used assessment of formal restrictions is a weighting scheme. The first such scheme is proposed in Hardin and Holmes (1997). The same scheme, illustrated in Table 1, is used by Golub (2003) and by Koyama and Golub (2006). A similar method, but with variations in the weights and their interpretations, is used by McGuire and Schuele in Chapter 12 of Findlay and Warren (2000). The scores from McGuire and Schuele are then employed by Kalirajan, McGuire, Hong and Schuele in regression estimates reported in Chapter 13 of Findlay and Warren (2000). The details of these methods are discussed next.

Coefficients of FDI restrictions

Calculating restrictiveness scores is a matter of identifying restrictive legislation in each country studied and weighting the restrictions according to a scheme like that shown in Table 1. These weightings attain their greatest usefulness in making statistical comparisons across samples of many countries, as illustrated in the next section.

Individual country scores are not necessarily as valuable. Calculating a country's restrictiveness score requires interpreting its regulations, and the interpretation can affect the score significantly. Indeed, since individual country scores may be either too volatile or insufficiently insensitive to changes in interpretation, they constitute only a rough guideline. Nevertheless, for the sake of completeness, a later section of the paper reports the restrictiveness scores for Canada's banking and insurance industries as calculated by Koyama and Golub (2006).

Table 1. Coefficients on formal FDI restrictions
(maximum 1.0)

formal restriction	Scores	Type of <i>Foreign</i>
<i>Equity limits</i>		
No foreign equity allowed	1.0	
1 to 19 % foreign equity allowed	0.6	
20-34% foreign equity allowed	0.4	
35-49 % foreign equity allowed	0.3	
50-74% foreign equity allowed	0.2	
75-99% foreign equity allowed	0.1	
no restriction but unbound	0.05	
<i>Screening and Approval</i>		
Investor must show economic benefits	0.2	
Approval unless contrary to national interest	0.1	
Notification (pre or post)	0.05	
<i>Other Restrictions</i>		
Board of directors/Managers	majority must be nationals or residents	0.1
	at least 1 must be national or resident	0.05
	must be locally licensed	0.025
Movement of people	no entry	0.1
	less than one year	0.075
	one to two years	0.05
	three to four years	0.025
Input and Operational Restrictions	domestic content must be more than 50%	0.1
	other	0.05
	<i>Total</i>	Between 0.00 and 1.00

a) If foreign equity is banned, then the other criteria become irrelevant, so that the index is at 1.0. It is possible that scores can sum to more than 1.0 when foreign equity is not totally banned, and in such cases, the index is capped at 1.0.

Source: OECD, Golub (2003). Adapted from Hardin and Holmes (1997).

3.2 Regression analyses

Cross-country comparisons of restrictiveness scores can be useful for establishing statistical effects. For example, one such analysis shows that on an inter-country basis, the net interest margins of the banking sector are likely to be larger in countries with restrictive attitudes toward FDI. However, these effects are not necessarily large; cf.

Barth, Caprio and Levine (2001, 2006). Moreover in a different type of study English (2002) suggests that differences between US and Canadian net interest margins are relatively small, despite considerable relative differences in FDI. The statistical studies may establish the direction of an economic effect, but assessing the quantitative impacts of a given policy change is a different matter.

Kalirajan and his coauthors, in Chapter 13 of Findlay and Warren (2000), estimate how trade and investment restrictions might affect the net interest margins of banks. The study employs a two stage regression. In the first stage, the net interest margin (NIM) of banks in an economy is modeled as dependent on bank capital, bank liquidity, and non-interest operating expenses using:

$$\ln(NIM_{ij}) = \alpha_0 + \alpha_1 \ln(K_{ij}) + \alpha_2 \ln(L_{ij}) + \alpha_3 \ln(NIE_{ij}) + \sum D_i$$

where

α_0 constant

K_{ij} capital of bank j in economy i

L_{ij} liquidity of bank j in economy i

NIE_{ij} net non-interest operating expenses of bank j in economy i

D_i economy specific dummy variable so that the sum of the dummy variables across economies equals $\alpha_0 + D_i = S_i$ in the second stage.

The results of the first stage regression analysis indicate that the capital ratio and net non-interest operating expenses are significant determinants of NIMs.

The second stage regression models the interest spread as a function of an economy's interest rate volatility, its banking market structure, and a score of its trade restrictiveness, as measured by

$$S_i = \beta_0 + \beta_1 IV_i + \beta_2 MS_i + \beta_3 TRI_i$$

where

S_i the interest spread for economy i : first stage constant $\alpha_0 + D_i$

IV_i interest rate volatility in economy i

MS_i market structure of the banking sector in economy i

TRI_i trade restrictiveness index score in economy i .

The trade restrictiveness index is calculated as described in the previous section. The second stage regression identifies interest rate volatility and the trade restrictiveness index as significant determinants of the interest spread. The main policy inference that might be drawn from this study is that net interest margins could decline as and when restrictions on FDI are reduced. However, banking products are sold in both global and local markets, and disentangling the effects for a particular country is a very difficult task. Moreover and as already mentioned, English (2002) does not find that net interest

margins differ significantly between the US and Canada.

3.3 Simulations

Nicoletti et. al. (2003) simulate the impact on inward FDI of removing foreign equity ceilings. Their simulations employ coefficients estimated through regression analysis. The percentage changes in inward FDI that are estimated to follow on three policy changes are indicated by the data in Table 2. Removal of foreign equity ceilings has the greatest effect, followed by relaxing of screening and approval procedures, and followed still further by easing of nationality requirements.

Table 2. The hypothetical effect of removing FDI restrictions
Average across countries

	Percent change in inward FDI position
Removal of foreign equity ceilings	77.9
Removal of approval and national interest tests	21.2
Easing of nationality requirements	10.1

Source: Nicoletti et. al., 2003

The simulations suggest that a policy of relaxing restrictions is likely to be beneficial, but as mentioned above establishing the quantitative importance of these effects for a given country is a very difficult task. Moreover, even though relaxing restrictions may affect the ownership characteristics of an industry, it still remains to establish the welfare effects of such ownership changes. Finally, concerns regarding the tradeoffs of FDI quantities against such other policy objectives as the desirability of a widely held financial industry (Canada, Department of Finance 2006) are not recognized in the kind of exercise just reported.

3.4 Informal considerations

Koyama and Golub's (2006) calculations suggest that Canada's attitudes toward foreign banking are still restrictive. However, their scores for the banking and insurance industries are almost identical, and it has not been customary to regard proposals for FDI in Canada's insurance industry as subject to restrictive policy. Moreover, the large domestically owned Canadian banks have formidable competitive advantages that are quite independent of policy restrictions. The advantages include established branch networks, automated teller machine networks, and product brands that all act as barriers to entry for potential competition.

Furthermore, if Canada pays a price for entry restrictions, it has not been detected in key efficiency ratios. Allen, Engert, and Liu (2006) find that Canadian banks are for the most part as efficient as US banks, although the same authors report that if Canadian

banks were larger they might be able to reap additional scale economies. The same authors also analyze the dispersion of cost-inefficiency measures and suggest that some Canadian banks are not as technologically advanced as their US counterparts. In a related but earlier work, Cetorelli and Gambera (1999) suggest that Canada's situation respecting the relative importance of foreign banks does not differ radically from that in a number of other countries.

Gouvin (2001) is especially critical of the effects of the widely held rule, which he views as reducing bank share prices through removing the effects of any control premium. However, since the widely held limitations apply both to Canadians and to foreigners, the OECD does not regard them as deviations from national treatment (Koyama and Golub, 2006). Nevertheless, the widely held limitations do appear to have had their historical impetus in attempts to discourage foreign investment.¹³

An indirect method of evaluating the restriction's current effects could involve comparing risk-adjusted returns earned by banks, using matched samples from different countries and from different industries, and controlling for whether the jurisdictions do or do not have share ownership restrictions. A research proposal with this theme is outlined in Section 6 below.

4. The Current Canadian Picture

This section briefly describes the major sectors comprising Canada's financial industry,¹⁴ the legislation governing each sector, and pertinent regulations regarding FDI. The section uses industry classifications commonly employed in Canadian policy discussions. The paper assesses virtually all industry sectors, since some have attracted significantly greater foreign entry than others. The section shows that past restrictions have had their greatest effect on the banking industry. Subsequent sections contrast the banking and insurance sectors to display how past policy has had a differential impact on the two industries.

¹³ Garvey and Giammarino (1998: 5) observe that "The original intent of ownership restrictions seems to have been the prevention of American ownership of the major Canadian banks." Their conclusions are based on legislation implemented after Citibank's attempted acquisition of the Mercantile Bank of Canada during the 1960s.

¹⁴ This section relies heavily on descriptions developed by Canada's Department of Finance. Most of the data in this section are taken from Canada, Department of Finance (2005).

4.1 Banks and trust companies

As of June 30, 2007 the banking industry included a total of 71 banks. The members of the Canadian Bankers Association comprised 15 Schedule I banks, 22 Schedule II foreign bank subsidiaries and 15 Schedule III foreign bank branches operating in Canada. In total, these institutions managed almost \$2.5 trillion in assets, with the foreign banks holding less than 10% of total assets. Banks hold over 55 per cent of the total assets of the Canadian financial services sector. The international operations of the six major domestic banks accounted for approximately 33 per cent of their net income revenues in 2003. On the other hand, foreign bank earnings in Canada account for about 7% of the earnings generated from Canadian operations.

Canada's banks operate over 8,000 branches and some 18,000 automated banking machines (ABMs) across the country. Canada has the highest number of ABMs per capita in the world and benefits from the highest penetration levels of electronic channels such as debit cards, internet banking and telephone banking. These components of the payments system are privately and domestically owned. However, foreign banks authorized under the Bank Act have the same access to the ABM networks as a domestic bank, and any company incorporated in Canada is eligible for membership in the Interac Association.¹⁵

Trust and loan companies offer similar services to banks, including accepting deposits and making personal and mortgage loans. Trust companies can also administer estates, trusts, pension plans and agency contracts. Although banks are not permitted to undertake trust activities directly, the largest trust companies are subsidiaries of the major banks.

¹⁵ For perspective's sake, it should be noted that Canadian banks offer retail ABM access in a number of Central and South American countries.

4.1.1 Formal Investment Restrictions

“Canada does not maintain foreign ownership restrictions for banks. Acquisitions of Canadian banks are linked to the new size-based ownership regime, which came into force in October 2001.” (Department of Foreign Affairs and International Trade website) Since Bill C-37 updated size definitions effective April 20, 2007, the widely held requirement now applies to banks with equity greater than \$8 billion. A widely held bank is one in which no person owns more than 20% of the voting shares or 30% of any class of non-voting shares. Nationals or residents must form a majority of the board of directors of a large Canadian bank, and at least half the board of a foreign subsidiary in Canada must reside in Canada. Medium-sized banks (\$2 to \$8 billion) can be closely held, although a public float of 35% of the voting shares is required.¹⁶ Small banks (under \$2 billion) are not subject to any ownership restrictions, other than a “fit and proper” test applied during the approval process. All foreign banks must obtain ministerial approval prior to entry.

The Superintendent of Financial Institutions reports details of applications for regulatory consent and (where required) ministerial approval for certain types of transactions, including incorporations and ownership changes. While many of the applications are made to satisfy minor technical requirements, OSFI reported that in 2005 “several” interested parties approached the Superintendent’s Office to discuss the incorporation of new closely held banks (domestic or foreign). Since 2001 eight new small banks have been established. There are no recorded applications to acquire block shareholdings in a large domestic bank.

4.1.2 Recent Legislative Changes

Bill C-37, which took effect on April 20, 2007, aimed to streamline financial legislation and to simplify approval processes facing foreign banks. The legislation provides that foreign banks can now establish a full-service branch, a lending branch, or a representative office. Foreign banks can invest in both regulated and unregulated financial services business, giving them the same powers as Canadian banks. Foreign banks are also permitted to invest in commercial businesses related to business done abroad and sometimes combined with financial activities, a power that is actually greater than the powers available to Canadian banks. Finally, under bill C37 near banks (foreign entities that are not regulated as banks abroad but engage in such banking activities as consumer lending) will not need entry approval. Ministerial approvals continue to be required (as in most OECD jurisdictions) and there is no change to the widely held rule. For the most part the changes, described in greater detail below, are unlikely to have significant effects on inward FDI. However they do indicate a willingness to identify and remove technical obstacles found in the legislation.

¹⁶ A Ministerial exemption from the 35% float requirement is available and a number of institutions, both domestic and foreign, have taken advantage of this exemption.

Changes in 2001 permitted foreign banks to make the same types of investments as Canadian banks, including investment in both regulated and unregulated financial services businesses. Under the new legislation, foreign banks are provided with the same flexibility to make temporary investments as Canadian banks, and with the same opportunities for engaging in specialized financing as is available to Canadian banks. The framework for near banks has also been made more transparent by describing the conditions for being designated as a real foreign bank. Foreign banks are now also permitted to invest in foreign entities through a Canadian holding company, so as not to impede their investment in foreign entities.

Foreign banks are now allowed to make arrangements with privately-run ABM networks in Canada so as to provide non-resident customers of those foreign banks with access to their funds in another country. The impact of this measure will depend on the ability of foreign banks to strike arrangements with the privately-run ABM networks, since the major resistance to foreign use of Canada's ABM networks stems from competitive considerations and from legislation that restricts foreign banks from establishing their own ABM networks in Canada. Foreign banks can also make arrangements with a member of VISA Canada or MasterCard Canada to provide their clients with access to their accounts at an ABM through the Plus or Cirrus networks.

The new legislation clarifies that unregulated financial branches of foreign banks cannot offer financial services or engage in funding in Canada. On the other hand, Bill C-37 eliminates the entry approval for near banks doing unregulated financial services, a change that results in the entry framework only applying to real foreign banks. This change was intended to reduce the regulatory burden for near banks. Finally, there are some also provincial restrictions regarding certain financial services. Alberta and Ontario impose foreign ownership limitations for trust companies, and Ontario imposes limitations on loan companies, mortgage broking companies, and collection agencies.

4.1.3 Informal Considerations

Gouvin (2001) argues that the widely held rule is inconsistent with global free trade norms. He suggests that "Canada will likely leave the widely held rule in place until such time as international pressure for trade liberalization forces its hand. Canada may eventually discard the rule, and one hopes that this will occur before the banking industry falls too much further behind its international rivals." On the other hand and as already mentioned, the widely held rule applies to both domestic and foreign shareholders and is not regarded by the OECD as a deviation from national treatment.

Regulation has not proved an impediment to HSBC Bank Canada, a subsidiary of HSBC North America Inc.¹⁷ and the most prominent foreign bank operating in Canada.¹⁸ HSBC entered the Canadian banking market through acquisitions of domestic banks, beginning with the Bank of British Columbia and its branch network in 1986, an acquisition that moved it from the 20th to the 9th largest bank in Canada. Several other acquisitions followed, and HSBC Bank is currently the 7th largest bank in Canada. HSBC Bank Canada is regulated as a medium size bank and is therefore not subject to the widely held rule. It is the only foreign bank in Canada with a strong presence in the retail sector, having a network of 138 branches. However, since the six large domestic banks operate about 8000 branches, HSBC Bank Canada cannot be said to be a proportionately significant competitor.

Foreign banks operating in Canada sometimes claim to have difficulty in capturing new lending business because Canadian companies with extensive ties to domestic banks may be concerned about disrupting those ties by doing some of their business with foreign banks. These claims are difficult to assess, particularly because they are offered informally and are not grounded in particular products or particular markets. Large international firms would likely feel considerably less tied to domestic Canadian banks than would, say, a medium-sized exclusively domestic operation.

4.2 Credit unions and caisses populaires

At the end of 2006 Canada's credit union sector consisted of 681 credit unions and 914 caisses populaires, with more than 3,600 locations and 4,500 ABMs. In 2003 the sector accounted for seven per cent of the domestic assets of Canada's deposit-taking financial institutions. Credit unions and caisses populaires have traditionally focused their efforts on retail businesses: residential mortgage financing, consumer credit and deposit services.

The sector is almost exclusively regulated at the provincial level in Canada. However, the national central, Credit Union Central of Canada, is chartered and regulated by the federal government under the Cooperative Credit Associations Act. In addition, six

¹⁷ HSBC North America Inc. is an indirectly held, wholly owned subsidiary of HSBC Holdings plc.

¹⁸ There is also competition from various forms of electronic banking such as ING DIRECT, from credit cards, department store cards and President's Choice Financial.

provincial credit union centrals have chosen to register under federal legislation as well as being subject to provincial regulation.

Over the years, the credit unions' share of domestic Canadian business has changed but little, and it may be that bank customers and credit union customers constitute relatively different populations. Nevertheless the picture varies from region to region. In particular, credit unions in British Columbia and caisses populaires in Quebec appear to compete vigorously for retail banking business. Moreover, the industry provides significant actual and potential competition in the establishment of the ABM network known as The Exchange.

The Exchange, a US-based network of approximately 150000 ABMs, was introduced in Canada by a number of BC Credit Unions, originally through a 1987 incorporation called Pacific Network Services. Most BC credit unions joined subsequently, as did the Bank of British Columbia. Through acquisition of the Bank of British Columbia, HSBC Canada became a member. Citibank has also joined, and The Exchange currently operates a network of more than 2000 ABMs throughout Canada. Since credit unions and caisses populaires are owned by their members, there is little likelihood of acquisition of the individual units by competitors, domestic or foreign.

4.3 Insurance

This section discusses the life and health insurance businesses as well as the property and casualty insurance businesses.

4.3.1 Life and health insurance

Canada's life and health insurance industry currently comprised 108 firms at the end of 2003, including companies incorporated both domestically and abroad. With increased consolidation in the industry, the four largest companies currently account for approximately 69 per cent of domestic general assets. Canada's life and health insurance companies had total domestic assets of \$315 billion in 2003, ranking them third among the country's financial industries, behind banks (\$1,257 billion) and the mutual fund industry (\$439 billion).

The domestic market share of Canadian companies has increased over the past decade from 68 per cent to 71 per cent of total premium income collected. At the same time, international operations have become increasingly important to Canadian insurers: foreign premium income accounted for 58% of the total premium income at year-end 2003. Reciprocally, there is a significant foreign presence in Canada.

4.3.2 Property and Casualty Insurance

The property and casualty (P&C) insurance industry in Canada provides coverage for all risks other than life and health. In 2001 the industry generated more than \$21 billion in net premiums, with automobile insurance being the largest single class. The industry has a wide variety of participants, ranging from direct insurers to reinsurers, government-provided auto insurance, and self-insurance arrangements such as reciprocal insurance exchanges and "captive" insurers owned by nonfinancial corporations. Of \$21 billion in net premiums in 2001, over \$11 billion was for automobile insurance. Most of the remainder came from property (personal and commercial) and liability insurance lines (see Chart 2). Government-owned corporations wrote \$4.1 billion in auto insurance premiums in Quebec, Manitoba and Saskatchewan.

Canada's P&C insurance industry is not highly concentrated. Rather it is comprised of more than 200 insurers (at the end of 2003), with the five largest having an estimated market share of 35% of total domestic assets. Foreign participants have a strong position in Canada's P&C market, accounting for 60 per cent of net premiums earned in Canada.

4.3.3 Regulatory restrictions

Insurance companies may be regulated at either the federal or the provincial level. With respect to prudential regulation, the federal government, through the Office of the Superintendent of Financial Institutions, supervises the federally incorporated domestic and foreign firms which account for over 90 per cent of the industry's premium income. Provincial governments are responsible for regulating the market conduct of all P&C insurers. The Federal widely held rule applies to Canada's two large, recently demutualized insurance companies. Like bank ownership rules, ministerial approval is required for a person who acquires or increases a significant interest in any class of shares of an insurance company.

4.3.4 Informal restrictions

Ontario and Quebec impose foreign ownership limits on insurance for licensing purposes.

Although the situation next described was changed in the 2006 budget, it is recorded here as an example of how government policies can function, perhaps inadvertently, as a barrier to FDI in some markets. Canada Mortgage and Housing Corporation (CMHC) currently controls about 70% of Canada's mortgage insurance market while Genworth Financial, a US-based multinational formerly known as GE Mortgage Insurance Canada, controls the remaining 30%. Previous legislation had limited government financial support to just those two incumbents, but as soon as other companies wanted to enter, the October 2006 Federal budget made the same kind of support available to new entrants. As a result, new entrants can now enter Canada's mortgage insurance market on the same terms as existing companies, provided they get

approval from the Federal authorities. At least three US-based companies have announced their intentions to do so. (Toronto Globe and Mail, Oct. 16, 2006.)

4.4 Securities dealers and exchanges

The securities sector plays a key role in Canada's financial system, operating capital markets and raising funds for businesses and governments. The industry is composed of integrated institutional and retail firms. In 2003 the integrated firms, which represent mainly the securities dealer affiliates of the six largest domestic banks, generated 73 per cent of the industry's revenues and offer services that cover all aspects of the industry. Another 201 securities firms captured the remaining 27 per cent of the business.

In 1999 Canada's major exchanges specialized, with the Toronto Stock Exchange responsible for trading senior equities, the Montreal Exchange assuming responsibility for the trading of derivatives, and the Canadian Venture Exchange (CDNX), handling the trading of junior equities. Subsequently the Toronto Stock Exchange acquired the CDNX as a part of the TSX Group. In May 2002 management of the Toronto Stock Exchange 300 Composite Index was taken over by Standard & Poor's and the index was renamed the S&P/TSX Composite Index.

Canada's securities industry is regulated at the provincial and territorial level. In addition, self-regulatory organizations such as the exchanges, the Investment Dealers Association of Canada and Market Regulation Services Inc. also play important regulatory roles. (The industry has recently announced that the IDA and Market Regulation Services may be merged into a single body.) The federal government continues to work with the provinces towards the development of a common securities regulator to promote greater efficiency in Canada's capital markets. There is widespread agreement that provincial securities regulation is cumbersome, complex, and a detriment to encouraging international business, and yet progress towards establishing a common securities commission is slow. These issues are discussed further below.

4.5 Mutual funds

The mutual fund sector consists of the manufacturers of mutual funds and the distributors, with a number of mutual fund companies involved in both segments of the business, notably those owned by the banks and the credit unions/caisses populaires. At the end of 2003, there were over 70 mutual fund companies sponsoring close to 1,900 mutual funds, and close to 200 firms involved in the sale of funds. The majority of mutual funds are either managed by the manufacturers (50 per cent) or by bank-owned companies (35 per cent). The industry can generally be divided into the manufacturers of funds and the distributors. However banks, credit unions and caisses populaires are involved in both sides of the industry.

The industry is governed by provincial and territorial securities laws. There is also extensive self-regulation by the Investment Dealers Association of Canada (IDA), the

Mutual Fund Dealers Association of Canada and Market Regulation Services Inc., a national, not-for-profit organization owned jointly by the Toronto Stock Exchange (TSX) and the IDA.

The mutual fund industry's share of assets held in foreign funds has also increased substantially since 1990: while foreign funds accounted for 17 per cent of total assets in 1990, by 2002 they made up fully 30 percent of fund assets. Some of this growth reflects the fact that the Canadian government increased the foreign content limits for RRSPs from 10 percent in 1990 to 30 percent in 2001. At the same time, the emergence of foreign clone funds, which are becoming increasingly popular among RRSP investors, may also have contributed to the growth of assets held in foreign funds.

4.6 Finance and leasing companies

The finance and leasing sector funds equipment and vehicle acquisition primarily with leases, but also offers secured loans and conditional sales contracts. In the case of leases, the lessor retains the ownership of the equipment or vehicle until the end of the lease, at which time the lessee can purchase the asset or return it to the lessor without further obligation. After banks and credit unions, the finance and leasing sector is the most important supplier of debt financing to Canadians. It is estimated that this industry has over \$100 billion in financing in place, with small and medium-sized businesses representing approximately 60 percent of its customers. Many finance companies are subsidiaries of manufacturers, or "captives," assisting in the financing of their parent company's products. Nevertheless there has been significant growth in the last decade, as the number of players in the Canadian marketplace, both domestic and foreign, has continued to increase.

4.7 Payments system

There are several components to the payments system in Canada: the Canadian Payments Association, the privately operated ABM networks, credit card networks, and the CLS Bank. The principal institutions relevant to the present discussion are the Canadian Payments Association and the privately operated ABM networks.

The Canadian Payments Association owns and operates the two primary systems in Canada for the clearing and settlement of payments: the Automated Clearing Settlement System and the Large Value Transfer System. The Automated Clearing Settlement System has a tiered participation, with 11 member financial institutions acting as direct clearers which handle the clearing and settlement of payment items for their own customers, as well as for customers that maintain accounts at the other financial institutions, known as indirect clearers. All banks operating in Canada, including authorized foreign banks, are required to be members. Credit union centrals, federations of caisses populaires, trust companies, loan companies and other deposit-taking institutions have been eligible for CPA membership since the Association's creation in 1980. Bill C-8, which came into force on October 24, 2001, broadened entitlement to membership in the Canadian Payments Association to life insurance companies,

securities dealers and money market mutual funds. The CPA now accepts membership applications from the newly eligible organizations and continues to provide their industry associations with information related to its membership application process. Applicants must meet certain requirements regarding the investment of their holdings and have access to an immediate and reliable source of liquidity. Canada's authorized foreign banks are members of the Canadian Payments Association.

Direct clearers (the large domestic banks including HSBC Bank Canada, a national organization of the credit union system, the Alberta Treasury Branches and the Caisse centrale Desjardins du Québec) must maintain settlement accounts with the Bank of Canada. Other financial institutions are indirect clearers and must make arrangements with the direct clearers for settlement of the payments they handle. The fees paid by indirect clearers are negotiated privately with a direct clearing member.

The Interac Association is a privately owned organization responsible both for a national network that provides shared cash dispensing at ABMs, and for the Interac Direct Payment for debit card transactions at the point-of-sale. Interac based transactions clear and settle over the Automated Clearing Settlement System operated by the Canadian Payments Association. Although it was originally started as a cooperative venture between Canadian financial institutions, membership in Interac is now open to any Canadian-incorporated company. The fee structure for belonging to the (non-profit) Interac association is negotiated between the association and its members on a cost recovery basis. It seems likely that access to the payments system has operated as an informal barrier to inhibit financial services investment in the past. Currently there are few barriers and those that do exist are in place for risk mitigation purposes.

HSBC Canada, Citibank Canada, and ING Direct are perhaps the most prominent foreign members of ABM networks in Canada. HSBC customers now have unlimited surcharge-free access at all HSBC, Bank of Montreal and The Exchange ABMs. Similarly, the ING Direct Card gives instant access to the 47,000 Interac machines in Canada. ING has arranged to pay the 75¢ interchange fee charged by the owner of the machine, up to four times per month. In some cases, some of the owners of bank machines have begun charging a surcharge in addition to the 75¢ interchange fee. ING credit cards can also be used to pay for purchases through Interac machines. Citibank Canada's website indicates that Citibank cards can be used without cost at The Exchange ABMs and with a charge at Interac machines. Citibank cards can also be used for direct purchases. Note that neither the Interac Association nor the Exchange own ABMs. ABMs generally have access to the Interac and credit card association networks. A relatively small number of ABMs also have access to The Exchange network.

Proposed legislative change will eliminate the need to obtain OSFI approval for processing information or data outside of Canada.

5. Restrictiveness Scores for Banking and Insurance

This section examines the principal issues involved in applying the Hardin and Holmes methods of quantifying restrictions to Canada's banking and insurance industries. The scores calculated by Koyama and Golub (2006) are shown in the next table.

Comparison of Ratings	Bank Sector (Koyama Golub)	Insurance Sector (Koyama Golub)
Equity limits		
No foreign equity allowed		
1 to 19 % foreign equity allowed		
20-34% foreign equity allowed		
35-49 % foreign equity allowed		
50-74% foreign equity allowed		
75-99% foreign equity allowed		
no restriction but unbound		
Screening and approval		
Investors must show economic benefits		
Approval unless contrary to national interest	0.050	0.050
Notification (pre or post)		
Other restrictions		
Boards of directors/managers		
Majority nationals or residents	0.100	
At least one national or resident		0.075
Must be locally licensed		
Movement of people		
No entry		
Less than one year		
One to two years		
Three to four years	0.025	0.025
Input and Operational Restrictions		
Domestic content more than 50%		
Limitation on proportion of total domestic assets		
Other	0.050	0.050
Total	0.225	0.200

Source: Koyama and Golub (2006). Details provided by Canada Department of Finance.

These comments are intended to help interpret the significance of the scores, reported by Koyama and Golub as being above the OECD average. The Koyama and Golub (2006) figures attempt to reflect deviations from national treatment (discrimination

against foreign investment) rather than the institutional environment generally. As a result, the widely held rule is not regarded as a limit on shareholdings in this table. There is little significant difference between the banking and insurance industry scores. There are no foreign shareholder limits that affect medium-sized and small US banks operating in Canada, but 35% of the shares of a medium-sized bank must trade publicly. On the other hand, some medium-sized banks, both domestic and foreign, have obtained ministerial exceptions to the 35% rule.

Although the widely held rule is not interpreted as discrimination against foreign investors, its existence could mean that no large Canadian bank is likely to be regarded by foreign investors as a suitable takeover target. Over the five year period surveyed by Barth, Caprio and Levine (2001) Canada received no external applications to acquire an interest in a large domestic bank. While a definitive assessment of the widely held rule is beyond the scope of this paper, banking industry figures show that on an asset basis foreign banks are proportionately less important to Canada than Canadian banks are to the rest of the world. Similarly, foreign earnings enjoyed by Canadian banks are proportionately large in relation to total Canadian bank earnings, while the percentage of total Canadian banking earnings enjoyed by non-Canadian banks is relatively small.

The situation is different with respect to insurance companies. About half the insurance industry is foreign owned, and Canadian insurance companies have substantial international operations. Foreign insurance companies earn a substantial proportion of the revenue generated in Canada, and the proportion of Canadian companies' earnings generated abroad is also a substantial proportion of Canadian firms' insurance earnings. Even though the regulations affecting banking and insurance have recently converged, the differences between the two industries result in part from past differences in the treatment of foreign investors, and in part from the mutual form of organization formerly used by many life and health insurance companies.

For comparative purposes, it is also helpful to record the Koyama-Golub scores for several other selected countries. The following table shows that Canada's restrictiveness scores exceed OECD averages, but not those of non-OECD countries. On the other hand, many of the selected countries, including France, Germany, Italy, Japan, New Zealand, and the UK report lower scores than Canada.

FDI Regulatory Restrictiveness Scores, Selected Countries

	Australia	Canada	France	Germany	Italy	Japan	Mexico
Insurance	.200	.200	.138	.116	.088	.025	.425
Banking	.300	.225	.094	.072	.144	.075	.525

	NZeland	Spain	UK	US	OECD Average	NonOECD Average
Insurance	.125	.226	.083	.175	.135	.206
Banking	.125	.182	.067	.275	.157	.211

Source: Koyama and Golub (2006), Table 1

Finally, some qualification of how the numbers might be interpreted also appears useful. This paper has suggested that informal restrictions and political attitudes are at least as important for understanding the influences affecting financial services FDI. Moreover, recent research suggests that focusing on restrictiveness scores might obscure the most important issues in policy toward FDI. Barth, Caprio and Levine (2006) conclude:

... political systems shape bank regulatory and supervisory policies, and these policies in turn influence the level of development of the banking sector, the efficiency with which banks intermediate savings, the fragility of the national banking system, [and] bank governance.... Given our findings regarding the connections between the operation of the political system and both the selection and influence of banking policies, our work sheds a skeptical light on attempts by international agencies to develop uniform best practice checklists for countries. ... Rather, our findings suggest that countries with political, legal, and regulatory systems that focus on improving and empowering the private market's ability to monitor and discipline banks are rewarded with well-functioning banking systems. (2006:316)

6. Sketch of Research Proposal

This section outlines a research proposal that appears to offer potential for uncovering share price effects that might be attributable to the widely held rule. If foreign investment in large Canadian banks were discouraged by the widely held rule, shares of the large Canadian banks could be subject to price discounts as a result. One way of assessing the presence of any such discount would use the Capital Asset Pricing Model to compare the prices of matched samples of bank shares from Canada with those from countries not having a widely held rule.

The matched samples could be structured in a number of different ways. First and probably most promising, the market required returns to the shares of large Canadian banks could be compared with the market required returns to the shares of similar large banks in countries not having the widely held rule. Second, the market required returns to large Canadian banks could be compared with the market required returns to large Canadian insurance companies. Although this comparison would be for a relatively small

sample, it could be used to help confirm or disconfirm the findings from the first sample. Third, the market required returns to large Canadian banks could be compared with the market required returns to Canadian foreign banks. This approach would offer another way of confirming or disconfirming the findings from the first sample, although of course other forms of discount might apply to the shares of foreign banks operating in Canada. For example, restrictions on the foreign banks' ability to do business in Canada could affect their market required rates of return.

In any event, if banks in the matched samples exhibit different market required rates of return, and if those differences can be attributed to Canadian banks subject to the widely held rule, the research would offer some evidence of an economic impact to the rule. On the other hand, a finding that no such differences in return exist would suggest that any impact of the widely held rule is less than some writers believe.

7. Conclusions

This section summarizes policy features that appear to have the potential for significantly affecting financial services FDI. It summarizes the likely economic impacts of these policies and presents some competitive issues posed by them. Finally, the section comments on the significance to financial services policy of establishing a national securities commission.

7.1 Significant aspects of regulation

The main formal limitations imposed by financial regulation are requirements to obtain ministerial approval. While it cannot definitively be established that the approval process acts as an impediment, it seems plausible to conjecture that a foreign bank would not enter a process if the outcome were thought to be doubtful. Moreover, the history of the widely held rule, along with the reluctance of previous governments and the present government to entertain domestic merger proposals might be interpreted by potential foreign investors as evidence of reluctance to entertain proposals for foreign share purchases. In any event, there have been no foreign applications for acquiring a significant degree of ownership in a large Canadian bank.

Existing methods of scoring restrictions provide one way of quantifying Canada's formal barriers, but the method has its limitations. Attempts, based on the restrictiveness scores, to quantify economic impacts are probably helpful insofar as determining the direction of the effects across a broad sample of countries is concerned. On the other hand, information regarding the magnitude of the effects seems likely to be less reliable, particularly for an individual country. A comparison of Canadian banking and Canadian insurance showed that the restrictiveness scores are not especially sensitive to differences in the industrial organization of the two industries.

7.2 Economic Impacts

Beyond the restrictiveness scores, the main discernible impacts of past policies appear to have affected the ownership composition and industrial organization of the banking industry. As evidenced by our comparison of banking and insurance, there are significant differences in the proportions of foreign ownership in the two industries. Essentially, Canadian banking is still a domestic industry with a fringe of foreign-owned small banks, while the insurance industry is considerably more international in both its ownership and the types of business it conducts.

On the basis of the simulations of Nicoletti et. al., easing the widely held rule on large Canadian banks could affect the ownership composition of the industry, but there is no firm evidence to suggest that net interest margins would be affected importantly by such a change. In addition, existing evidence does not indicate that Canadian banks' efficiency is affected significantly by existing policy constraints.

There is some possibility that Canadian banks are not large enough to enjoy all available economies of scale, implying that Canadian banks might be inefficient relative to the world's largest. Either allowing domestic mergers or relaxing the widely held rule are two ways of enhancing the possibilities that Canadian banks could operate more efficiently by becoming larger. On the other hand, Walter (2005) argues that efficiency may be compatible with a relatively wide range of asset sizes, and there is little evidence that one type of intermediary structure clearly dominates others.

Finally it is not clear that interest rate differentials would be affected by greater foreign investment, but the prices of some services like credit cards might be.

7.3 Competitive issues

The most prominent current example of a foreign presence is that of HSBC Bank Canada, which operates the country's seventh largest bank, a business with some 140 branches. The asset and branch sizes of HSBC Bank Canada result mainly from acquisitions. Since legislation defines HSBC Bank Canada as a medium-sized establishment, it is not subject to the widely held rule. Although HSBC does compete with the six large domestic banks, it is a relatively small competitor in terms of both assets and branches.

The payments system may have presented an informal barrier to FDI in the past. However any previous obstacles to joining Canada's ABM networks appear to be changing and several foreign bank subsidiaries are currently members of Interac. The current competing ABM network (The Exchange) was originally set up by the credit unions in Canada, using a previously established network operating in the U.S. It is also attracting foreign bank subsidiary membership and may ultimately prove a competitive challenge to Interac.

7.4 Other considerations

The absence of a federal securities commission constitutes a serious impediment to issuing and trading securities in Canada. Canada, almost uniquely among WTO countries, has a fragmented, provincial approach to governing the securities industry. This approach is costly both to the players and to the country, and could well have the effect of impeding both FDI and concomitant technological progress.

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